

**ST 02-31**

**Tax Type: Sales Tax**

**Issue: Audit Methodologies and/or Computational Issues  
Books And Records Insufficient**

**STATE OF ILLINOIS  
DEPARTMENT OF REVENUE  
OFFICE OF ADMINISTRATIVE HEARINGS  
SPRINGFIELD, ILLINOIS**

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<b>THE DEPARTMENT OF REVENUE</b>	)	
<b>OF THE STATE OF ILLINOIS</b>	)	
	)	<b>Docket No. 01-ST-0000</b>
<b>v.</b>	)	<b>IBT # 0000-0000</b>
	)	<b>NTL # 00-00000000000000</b>
<b>ABC FOODS, INC.</b>	)	
	)	
<b>Taxpayer</b>	)	

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**RECOMMENDATION FOR DISPOSITION**

Appearances: Matthew Crain, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; R. Kurt Wilke of Barber, Segatto, Hoffee & Hines for ABC Foods, Inc.

Synopsis:

The Department of Revenue (“Department”) conducted an audit of ABC Foods, Inc. (“taxpayer”) for the period of July 1997 through December 1999. At the conclusion of the audit, the Department issued a Notice of Tax Liability to the taxpayer for additional retailers’ occupation tax (“ROT”). The taxpayer timely protested the Notice. At the pretrial conference in this case, the parties stated that the issue is whether the Department’s calculation of the taxpayer’s sales for the audit period is correct. The following issues are encompassed by the issue raised at the pre-trial: (1) whether the

Department was justified in going outside of the taxpayer's books and records to determine the audit liability; (2) whether the Department's method for preparing the corrected return meets a minimal standard of reasonableness; and (3) whether the taxpayer's evidence was sufficient to overcome the Department's prima facie case. After reviewing the record, it is recommended that this matter be resolved partially in favor of the taxpayer.

FINDINGS OF FACT:

1. The taxpayer operates two Mexican restaurants/bars; one is in Anywhere, Illinois and the other is in Almost Anywhere, Illinois. (Tr. pp. 12, 118)
2. The Department conducted an audit of the taxpayer's business for the period of July 1997 through December 1999. (Dept. Ex. #1)
3. For the Almost Anywhere business, the taxpayer provided Z-tapes, which are cash register tapes, for the auditor's review. (Tr. p. 12)
4. For the Almost Anywhere business, the taxpayer's cash registers were registering the wrong tax rate for part of the audit period; they registered 7.25% instead of 6.25%. This error was corrected in May of 1998. Also, up until August of 1998, the taxpayer omitted Almost Anywhere's credit card sales, over-rings, and cash paid out from the sales tax returns. (Dept. Ex. #2, pp. 2-3; Tr. p. 13)
5. For the Almost Anywhere location, the taxpayer's ledger book showed sales of \$209,950 for 1998. For the same time period, the taxpayer's deposits showed \$214,850, and the cash register tapes minus over-rings showed \$222,101. (Dept. Ex. #2, p. 4)

6. For the Anywhere restaurant/bar, the taxpayer had Z-tapes for its bar sales but not for its food sales. For the food sales, the taxpayer used “check tickets,” which were paper tickets that were used to record the sales. The taxpayer wrote the customer’s order on a ticket and kept the ticket as a record of the sale. (Tr. pp. 12, 14, 119-20)

7. The taxpayer did not use any method, such as numbering the tickets, to insure that a ticket would not be lost. (Tr. p. 14)

8. For 1998, the cost of goods sold from the taxpayer’s books and records was approximately \$35,000 higher than the cost of goods sold reported on the taxpayer’s federal income tax return. (Dept. Ex. #2, p. 5; Dept. Ex. #3; Tr. p. 15)

9. The auditor requested information from the taxpayer’s vendors to verify the taxpayer’s purchases. The auditor did not receive responses from all of the vendors. For the ones that responded, the auditor compared the information to the amounts from the taxpayer’s check registers. The auditor found only minor discrepancies between the amounts from the taxpayer’s check register and the amounts that the vendors said the taxpayer purchased. (Tr. pp. 15-16)

10. Both parties agree that the amount that the Department determined to be the cost of goods sold from the taxpayer’s records is accurate. (Dept. Ex. #2, p. 14; Tr. p. 88)

11. If the taxpayer’s books and records are insufficient, then the auditor uses other methods to determine gross sales. These include either (1) applying an industry average mark-up to the cost of goods sold; (2) applying an actual mark-up based on the selling prices to the cost of goods sold; or (3) reviewing all the cash in and cash out. (Tr. pp. 18-19)

12. The taxpayer did not provide the auditor with the owner's personal bank records so that the auditor could review all the cash to verify sales. (Tr. p. 19)

13. The auditor did not perform a weighted-average gross margin analysis based on the selling prices because it was too time consuming. (Tr. p. 19)

14. The auditor estimated the taxpayer's sales by applying an industry average markup to the taxpayer's cost of goods sold. The auditor stated that the industry average was obtained from a Robert Morris Associates ("RMA") book. (Tr. pp. 20, 29)

15. The auditor could not produce the RMA document that was used to determine the industry average markup. She did not know what year the average came from, and said that the number may have come from an average of several years. She did not know the sample size that the number she used was based on. (Tr. pp. 29-31, 62-63)

16. The auditor projected sales by using the industry standard of 42.9% cost of goods sold to sales ratio. This results in a gross profit margin of 57.1%. (Dept. Ex. #2)

17. The taxpayer provided the Department with an RMA booklet for 2001-2002 that shows that for drinking establishments with sales between zero and one million, the average gross profit is 56.6%. This is based on a sample size of 75. For the larger businesses, the gross profit is larger. (Taxpayer Ex. #7; Tr. pp. 29-30)

18. The taxpayer's accountant estimated the taxpayer's sales by using a weighted-average gross margin analysis that averaged the actual price of the taxpayer's items. Based on this analysis, the accountant determined that the taxpayer's gross margin was approximately 51%. (Taxpayer Ex. #5; Tr. pp. 89-96)

19. In order to perform the weighted-average gross margin analysis, the taxpayer's accountant had to determine the product mix for the taxpayer's business and

then determine an average price for that product. For example, he had to calculate the percentage of beer sales for a particular brand of beer and determine an average price for that beer. The taxpayer did not provide documents to support the accountant's determination of the product mix or the average price of the product. (Tr. pp. 89-93)

20. The taxpayer presented a Dun & Bradstreet Information Services booklet that provides industry averages for 1993-94. Dun & Bradstreet shows that for drinking establishments the average gross profit was 52.1%, with a sample size of 313. The average does not delineate between large and small businesses. (Taxpayer Ex. #8; Tr. pp. 83-84)

21. The Department prepared a corrected return for the taxpayer that showed additional tax due of \$20,107 for the period of July 1, 1997 through December 31, 1999. A copy of the corrected return was admitted into evidence under the certificate of the Director of the Department. (Dept. Ex. #1)

#### CONCLUSIONS OF LAW:

The Retailers' Occupation Tax Act ("ROTA") (35 ILCS 120/1 *et seq.*) imposes a tax upon persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. Sections 4 and 5 of the ROTA provide that the certified copy of the corrected return issued by the Department "shall be prima facie proof of the correctness of the amount of tax due, as shown therein." 35 ILCS 105/12; 120/4; 120/5. However, the Department's corrected return is only prima facie proof if the Department has met some minimum standard of reasonableness in preparing the corrected return. Vitale v. Department of Revenue, 118 Ill.App.3d 210, 212 (3<sup>rd</sup> Dist. 1983). The Department is

required to correct the tax return according to its "best judgment and information." 35 ILCS 120/4. There is no requirement that the Department substantiate the basis for its corrected return at the hearing. Masini v. Department of Revenue, 60 Ill.App.3d 11, 14 (1st Dist. 1978). When the corrected return is challenged, however, the method that was used by the Department in correcting the return must meet some minimum standard of reasonableness. Id.; Elkay Manufacturing Co. v. Sweet, 202 Ill.App.3d 466, 470 (1<sup>st</sup> Dist. 1990).

The taxpayer has called into question the method used by the Department to correct its tax return. The taxpayer contends that the Department's method was not minimally reasonable because (1) the Department was not justified in going outside the taxpayer's books and records, and (2) the Department was not justified in using a "fictitious" mark-up that was based on an undocumented source. In response, the Department asserts that with respect to the taxpayer's first argument, this issue was not raised by the taxpayer until its post-hearing brief. The Department, therefore, contends that the sufficiency of the taxpayer's books and records should not be considered to be an issue in this case.

At the pre-trial conference in this case, the parties stated that the issue is "whether the Department's calculation of the taxpayer's sales for the audit period is correct." During the hearing, there was extensive documentary and testimonial evidence concerning the taxpayer's books and records and whether they were accurate. The issue that the Department claims was first raised in the taxpayer's post-hearing brief was actually raised during the hearing, and the Department did not object to any of this evidence. In addition, in order to calculate the taxpayer's sales, the Department had to

decide whether the taxpayer's books and records provided a sufficient basis from which to make its calculations. It is therefore implicit that in order to resolve the issue that was raised at the pre-trial, it must first be determined whether the taxpayer's records provided an adequate basis from which to calculate the sales. This issue was properly raised by the taxpayer in its post-hearing brief.

The taxpayer contends that its records were complete and accurate, and the Department should not have gone outside the records to estimate the liability. The taxpayer argues that the reasons that the auditor gave for going outside the records do not justify her actions. The taxpayer believes that this case is similar to Goldfarb v. Department of Revenue, 411 Ill. 573 (1952), where the Department disregarded the taxpayer's sales records and estimated the taxpayer's sales. The court found that the taxpayer's records were adequate, and the court dismissed the liability.

The evidence in the present case supports a finding that the Department was justified in going outside the taxpayer's books and records to determine the audit liability. The auditor's history worksheet indicates that for the Almost Anywhere location, the taxpayer's ledger book showed sales of \$209,950 for 1998. For the same time period, the taxpayer's deposits showed \$214,850, and the cash register tapes minus over-rings showed \$222,101. (Dept. Ex. #2, p. 4) This discrepancy alone is sufficient to doubt the accuracy of the taxpayer's records. The taxpayer presented no evidence that would explain this error. It is important to note that this error occurred in the records at the Almost Anywhere location, where the taxpayer supposedly had a "pretty good" set of records. (Tr. p. 12)

The method for recording sales at the Anywhere location was even less accurate than the method used in Almost Anywhere. The taxpayer had Z-tapes for its bar sales, but for its food sales it used “check tickets,” which were paper tickets that were used to record the sales. The taxpayer wrote the customer’s order on a ticket and kept the ticket as a record of the sale. This method has obvious inherent flaws. There is no indication in the evidence that these tickets were numbered or that any other method was employed to insure that a ticket would not be lost or misplaced before entering the sale into a journal. The testimony of the taxpayer’s accountant that this method is more accurate than register receipts is not credible. (Tr. p. 115) Without assurance that every effort was extended to insure the accuracy of this method, it is not reliable. Because the taxpayer’s records were not accurate or reliable, the auditor was justified in going outside the taxpayer’s books and records to determine the liability.

The taxpayer argues that the Department was not justified in estimating the liability by using a “fictitious” markup figure based on an undocumented source. The taxpayer notes that the auditor used a figure that was provided to her by her support staff. (Tr. p. 62) The auditor did not know if the information that she received from the support staff included the sample size. (Tr. p. 62) The auditor then said that the support staff used several years of RMA books to arrive at the industry standard. (Tr. p. 63) She did not know which years were used. (Tr. p. 63) The auditor did not have the source document that was used to determine the industry standard for the markup. (Tr. pp. 29-31, 62)

Even though the Department did not provide the documents that were used to find the industry standard, the figure that it used was minimally reasonable. The Department



used a cost of goods sold to sales ratio of 42.9%. The taxpayer has proposed that this figure should be approximately 49% based upon its accountant's calculations in the weighted-average analysis. Although the taxpayer used a different method for calculating this ratio, nothing indicates that the Department's figure was unusual or outside the realm of a realistic estimate. The Department's figure and method for preparing the corrected return were minimally reasonable, and therefore the corrected return is prima facie correct.

Once the Department has established its prima facie case, the burden shifts to the taxpayer to overcome this presumption of validity. A.R. Barnes & Co. v. Department of Revenue, 173 Ill.App.3d 826, 832 (1st Dist. 1988). To prove its case, a taxpayer must present more than its testimony denying the accuracy of the Department's assessment. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill.App.3d 203, 217 (1st Dist. 1991). The taxpayer must present sufficient documentary evidence to support its claim. Id.

The taxpayer argues that even if the Department's method was minimally reasonable, the taxpayer has presented sufficient evidence to overcome the Department's prima facie case by showing that the taxpayer's method for calculating the taxpayer's margin was more accurate. The taxpayer contends that a significant number of its sales included "\$1.00 beer specials" while the average price for beer in Anywhere was between \$2.00 and \$2.50. The taxpayer, therefore, claims that it did not have the "industry average" margin on its sales. The taxpayer's accountant, Mr. Doe, used a pricing mark-up analysis for estimating sales from cost of goods sold; the Department's auditor acknowledged that this was an appropriate analysis but chose not to use it because it was

too time-consuming. (Tr. p. 19) The taxpayer notes that the Department did not challenge Mr. Doe's analysis.

The Department argues that the taxpayer failed to present sufficient evidence to overcome the Department's prima facie case. The Department notes that the taxpayer did not bring any books or records to the hearing, and the Department's exhibits did not contain original or copies of the taxpayer's records. The Department contends that the taxpayer cannot overcome the Department's prima facie case by simply offering alternative hypotheses or arguing that the Department's methodology is flawed. The Department states that the taxpayer must produce competent evidence identified with its books and records.

The Department notes that the taxpayer's evidence consisted of testimony from the taxpayer's owner and its accountant and several documents that do not include records. The document upon which the taxpayer relies most heavily is a weighted-average gross margin analysis that was prepared by the taxpayer's accountant. (Taxpayer Ex. #5) Mr. Doe stated that this analysis was based upon his review of the taxpayer's records and business information, but the records were not produced at the hearing. The Department contends that this analysis was prepared in anticipation of the litigation in this matter and should not be relied upon.

The taxpayer argues that the Department's contention concerning books and records is misplaced because there is no dispute as to what the books and records show. The taxpayer notes that all of the data concerning the taxpayer's sales and cost of goods sold was introduced by the Department in its exhibit number three. The taxpayer states that this is not only a sufficient evidentiary record of the taxpayer's books and records,

but it is also an evidentiary admission by the Department as to what the books and records show. The taxpayer states that it would be of no benefit to bring in boxes of sales tickets and register tapes when the parties agree as to what they add up to, and they have put that number into evidence.

The taxpayer's arguments concerning the books and records are partially correct. The Department's exhibit number three contains the auditor's summary of the taxpayer's records concerning purchases and sales for the audit period. The auditor verified the taxpayer's purchases by requesting information from the taxpayer's vendors. The auditor found only minor discrepancies between the amounts from the taxpayer's check register and the amounts that the vendors said the taxpayer purchased. Both parties agree that the amount that the Department determined to be purchases, which was consistent with the taxpayer's records, was accurate.

As for the sales, the auditor prepared summaries of the taxpayer's records for sales for each month during the audit period. Although the Department does not believe that the amount in the records accurately reflects the actual sales, the parties do not dispute that the auditor's summaries of the sales records accurately reflect what is in the taxpayer's records. It would serve no purpose to have the taxpayer bring in its records when there are accurate summaries of the purchase and sales records in the evidence.

Nevertheless, the taxpayer has failed to present evidence from its books and records to substantiate its weighted-average gross margin analysis. The taxpayer's accountant testified that in order to perform this analysis, he first needed to determine the product mix. (Tr. p. 89) For example, he determined that 55% of the taxpayer's beer sales were for Bud Light, 25% were for Miller Light, and 20% were for other beers.

(Taxpayer Ex. #5) However, the taxpayer did not provide documents from its records to support his accountant's conclusions concerning the product mix. In addition, the taxpayer's accountant determined the price of each of these categories of beer for each day of the week in order to calculate the weighted-average price of a beer. Once again, the taxpayer did not present documents identified with its books and records in order to substantiate the price of the beer that it sold. The only evidence that the taxpayer presented concerning the price of the beer was seven newspaper advertisements that showed, inter alia, that the taxpayer sold beer on Saturday nights for \$.99. These advertisements do not support the accountant's findings concerning the prices on other days of the week or other items that were sold by the taxpayer.

Despite the taxpayer's lack of documentary evidence to support its gross margin analysis, the taxpayer provided documentary evidence that substantiates a mark-up figure that is different than the one used by the Department. The taxpayer provided a Dun & Bradstreet Information Services booklet that provides industry averages for 1993-94. This booklet shows that for drinking establishments the average gross profit was 52.1%. The taxpayer also provided the Department with an RMA booklet for 2001-2002 that shows that for drinking establishments with sales between zero and one million, the average gross profit was 56.6%. In response to this information that was provided by the taxpayer, the Department did not substantiate the mark-up figure that it used. The only evidence presented by the Department was the auditor's testimony, and she was uncertain as to how the figure was determined.

The parties have agreed on the amount of the taxpayer's cost of goods sold for the audit period, and the only disagreement concerns how much the cost of goods sold should

be marked-up to determine the taxpayer's sales. The taxpayer has provided documents to substantiate an average mark-up figure for drinking establishments. Once the taxpayer has presented evidence that is not so inconsistent or improbable as to be unworthy of belief, it has overcome the Department's prima facie case and the burden shifts back to the Department to prove its case by competent evidence. See Novicki v. Department of Revenue, 373 Ill. 342 (1940). In this case, the Department was not able to justify the mark-up figure that it used. The mark-up figure should therefore be determined from the information provided by the taxpayer. Because neither booklet provided by the taxpayer covers the audit period in this case, it is reasonable to take an average of the two figures. This would result in a gross profit margin of 54.35%, and the cost of goods sold to sales ratio would be 45.65%.

Recommendation:

For the fore-going reasons, it is recommended that the Department's assessment be revised by using an average of the gross profit margin figures from the booklets provided by the taxpayer to estimate the taxpayer's sales for the audit period. The gross margin should be 54.35%, and the cost of goods sold should be marked-up accordingly.

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Linda Olivero  
Administrative Law Judge

Enter: November 27, 2002